STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

South Beloit Water, Gas and Electric Company)	03-0676	
)		
Proposed general increase in natural gas)		
rates.)		Consolidated
South Beloit Water, Gas and Electric Company)	03-0677	
)		
Proposed general increase in water rates.)		

INITIAL BRIEF OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

JOHN C. FEELEY
Office of General Counsel
Illinois Commerce Commission
160 North LaSalle Street, Suite C-800
Chicago, Illinois 60601
(312) 793-2877

Counsel for the Staff of the
Illinois Commerce Commission

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NOW COMES the Staff of the Illinois Commerce Commission ("Staff") through its attorney, and files its Initial Brief in the above-captioned proceeding.

INTRODUCTION

On October 10, 2003 South Beloit Water, Gas and Electric Company ("SBWGE" or "Company") filed tariff sheets in which it proposed a general increase in natural gas rates to be effective January 1, 2004. The Illinois Commerce Commission ("Commission") suspended those tariff sheets effective January 1, 2004 in a suspension order dated November 5, 2003 (Docket No. 03-0676). On October 15, 2003 SBWGE filed tariff sheets in which it proposed a general increase in its water rates to be effective January 1, 2004. The Commission suspended those tariff sheets beginning on January 1, 2004 in a suspension order dated November 5, 2003, (Docket No. 03-0677).

On November 25, 2003, a prehearing conference was held at which time Staff and SBWGE came to an agreement on the schedule and SBWGE made a motion to consolidate docket nos. 03-0676 and 03-0677.

On December 4, 2003 SBWGE filed a request for rehearing on the suspension orders in both Docket Nos. 03-0676 and 03-0677. Staff opposed SBWGE's request for rehearing. On December 17, 2003, the Commission denied SBWGE's request for rehearing.

The following witnesses testified on behalf of the Staff: Bonita A. Pearce, Burma C. Jones, Thomas Q. Smith, Janis Freetly, Cheri L. Harden, William D. Marr, and Eric Lounsberry.

The following witnesses testified on behalf of SBWGE: Douglass K. Carlson adopting the testimony of Jill Osterholz, Sonya M. Kessinger, Lawrence J. White, Martin W. Seitz, and Enrique Bacalao.

A hearing was held on May 19, 2004 at the Commission's offices in Springfield at which time the record was marked heard and taken.

Staff and the Company were able to come to agreement on most of the issues in this consolidated matter. However, the following issues remain in dispute and must be decided on by the Commission: Savings Sharing Expense-Gas (I, D, 2, g); Cost of Common Equity (I, E, 5); Rate Design, Gg-2 (I, G, 3); and whether the Company needs to revise its affiliate contract for gas with Wisconsin Power and Light Company ("WPL") (III, B). The positions set forth by Staff on these contested issues are reasonable and therefore should be adopted by the Commission along with those adjustments which the Company and Staff came to an agreement on.

ARGUMENT

I. Revenue Requirement- Gas & Water

A. Calculation of Revenue Requirement- Gas & Water

Staff's position is reflected in the revenue requirement schedules submitted as ICC Staff Ex. 1.0, Schedules 1.1 through 1.6 for Gas and Water. There were no changes to any of those schedules in Staff's rebuttal testimony or subsequently.

B. Selection of Test Year- *Gas & Water*

The Company used a historical test year of 2002 (Company Ex. MWS-1 Water, p. 13 and Company Ex. MWS-1 Gas, p. 13). Staff did not take issue with the selection of 2002 as the test year.

C. Rate Base- *Gas & Water*

1. Cash Working Capital- Gas & Water

The Company agreed with Staff's proposed adjustments to Cash Working Capital (excluding the effects of the remaining contested issues), in the rebuttal testimony of Martin W. Seitz (Company Ex. MWS-2 Gas & Water, p. 2 of 10, lines 11 – 16.)

Schedules 1.10 present Staff's adjustments to calculate the Cash Working Capital component of rate base after giving effect to Staff's adjustments to the 2002 test year revenue requirement for gas and water, respectively. Staff's adjustments utilize the same methodology as reflected in the Company's Schedules B-5.

Therefore, there is no contested issue for the Commission to make a decision on regarding Staff's adjustment to Cash Working Capital because the methodology used by Staff is the same as that used by the Company. Accordingly, the final Cash Working Capital adjustments should reflect the adjustments approved by the Commission in the final revenue requirements for gas and water, respectively.

2. Working Capital Allowance Related to Gas in Storage- *Gas*

Staff recommended a reduction of $135,410 to the Company's requested working capital allowance associated with its gas in storage. (ICC Staff Ex. 7.0, pp. 2-3)

The Company provided no testimony to dispute Staff's recommendation. Staff's adjustments resulted from three areas – using actual numbers instead of estimated numbers, removing hedging costs, and accounting for the higher than average volumes of natural gas maintained in storage during the 2002 test year. (Id., p. 3)

Staff noted the Company's requested level of working capital allowance associated with gas in storage was based upon estimated data instead of actual data. (Id. p. 4) The Company's follow-up responses to Staff data requests ENG 1.8 and 1.11 indicated that its requested level of gas in storage was based on the monthly amounts booked to its general ledger. (Id.) These same responses indicated the general ledger values were the current months estimates as well as true-ups for one or more previous months. (Id.) Staff recommended the Commission base the Company's working capital allowance associated with gas in storage upon actual data instead of estimated data and calculated the result of that change was a reduction to the working capital allowance of $11,148. (Id., p. 4) The Company did not dispute Staff's recommendation.

Next, Staff noted the Company's requested level of working capital allowance associated with gas in storage included hedging costs. (Id. p. 5) Staff also noted that the Company had not historically charged its customers with any costs associated with financial hedges and the Company's responses from Docket No. 02-0728 (the Company's 2002 purchased gas adjustment reconciliation) indicated it was not involved in any risk management or hedging programs. (Id.) Therefore, Staff recommended the Commission remove any hedging costs from the Company's working capital allowance, which would result in a reduction to the requested allowance of $1,546. (Id.) The Company did not dispute Staff's recommendation.

Finally, Staff noted the Company's requested test year volume of natural gas and its associated value was not representative of the volume of gas in storage the Company would maintain in the future. (Id., p. 6) In particular, Staff indicated the Company stated the weather during the 2002 test year was extremely warm, which caused the Company to not withdraw as much of its storage gas in the test year. (Id.) Further, ICC Staff Exhibit 7.0, Schedule 7.4 Gas indicated the natural gas inventory maintained by the Company during the test year exceeded the gas inventory maintained by the Company during any prior historical period. (Id., p. 7) Therefore, Staff recommended the Commission rely on an historical average based on the test year levels as well as three prior years to normalize the Company's requested volumes. (Id.) Staff also noted that it had made a similar adjustment in the recent AmerenCIPS and AmerenUE rate cases, Docket Nos. 02-0798, 03-0008, 03-0009 (Consolidated), and that the Commission in its October 22, 2003 Order agreed with Staff's recommendation. (Id.) Staff calculated the use of the historical average for the volume gas in storage resulted in a reduction of $122,717 to the Company's requested working capital allowance for gas in storage. (Id.) The Company did not dispute Staff's recommendation.

Staff recommended three areas of adjustment to the Company's requested working capital allowance for gas in storage. The Company did not dispute any of the Staff's recommendations. Therefore, the Commission should accept Staff's recommendations and reduce the Company's working capital allowance for gas in storage by $135,410.

3. Accumulated Depreciation Reserve- *Gas*

The Company agreed with Staff's proposed adjustment to the Accumulated Depreciation Reserve - Gas, in the rebuttal testimony of Martin W. Seitz (Company Ex. MWS-2 Gas, p. 2 of 10, lines 11 – 16.)

Schedule 1.7 Gas reflects Staff's adjustment to match the pro forma increase in the depreciation expense (Schedule C-3, item J) with a corresponding impact on the depreciation reserve. Staff's adjustment is calculated as the difference between the Company's pro forma depreciation expense adjustment (J) of $11,471 (Schedule C-3) and the $4,704 increase to the depreciation reserve for CWIP included in the December 31, 2002 balance. The reason for Staff's adjustment is that the pro forma increase in depreciation expense must be accompanied by a corresponding increase in the reserve for accumulated depreciation.

There is no contested issue for the Commission to make a decision on regarding Staff's adjustment to the Accumulated Depreciation Reserve - Gas because the Company agreed with Staff's adjustment in the rebuttal testimony of Martin W. Seitz. (Company Ex. MWS-2 Gas, p. 2 of 10, lines 11 – 16.)

4. Materials and Supplies- *Gas*

The Company agreed with Staff's proposed adjustment to Materials and Supplies - Gas, in the rebuttal testimony of Martin W. Seitz (Company Ex. MWS-2 Gas, p. 2 of 10, lines 11 – 16.)

Schedule 1.8 Gas presents Staff's adjustment to reduce the Company's test year materials and supplies inventories amount by the associated accounts payable. This adjustment limits the amount of materials and supplies inventories reflected in rate base

to the amount that has been funded by investors. The Company did not deduct accounts payable from materials and supplies. Accounts payable are an integral component of a utility's materials and supplies inventory. An accounts payable represents "vendor financing" of purchased merchandise until it has been paid in full. Since the vendor is financing these purchases until paid, the investors have no investment in the related materials and supplies. The materials and supplies inventories included in rate base should be reduced by the amount of accounts payable related to the inventories because the Company should not earn a return on inventory until the investors have funded it. Staff's proposed adjustment limits the portion of materials and supplies on which the Company is entitled to earn a return to the portion that represents a cash investment by the Company.

There is no contested issue for the Commission to make a decision on regarding Staff's adjustment to Materials and Supplies Inventory – Gas because the Company agreed with Staff's adjustment in the rebuttal testimony of Martin W. Seitz. (Company Ex. MWS-2 Gas, p. 2 of 10, lines 11 – 16.)

5. Customer Deposits- *Water*

The Company agreed with Staff's proposed adjustment to Customer Deposits - Water, in the rebuttal testimony of Martin W. Seitz. (Company Ex. MWS-2 Water, p. 2 of 10, lines 11 – 16)

Schedule 1.9 Water presents Staff's adjustment to reflect in the Company's test year water rate base the 13-month average balance of customer deposits. The Company did not reflect any customer deposits in its rate base.

Staff proposed a 13-month average for the period December 31, 2001 through December 31, 2002 as the basis for this adjustment because the use of a 13-month average is more representative of the test year activity than a point in time such as a year-end balance.

There is no contested issue for the Commission to make a decision on regarding Staff's adjustment to Customer Deposits - Water because the Company agreed with Staff's adjustment in the rebuttal testimony of Martin W. Seitz. (Company Ex. MWS-2 Water, p. 2 of 10, lines 11 – 16)

D. Operating Revenues and Expenses- *Gas & Water*

1. Income- Gas & Water

a. PGA Revenue and Cost of Gas- Gas

To facilitate the calculation of uncollectible accounts expense for the test year, Staff witness Jones proposed an adjustment to increase both revenue and expense by the amount of gas purchased in the test year. (ICC Staff Ex. 2.0, Sch. 2.5 Gas.) The adjustment was accepted by the Company. (Company Ex. MWS-2, p. 2.)

Staff's uncontested adjustment to PGA revenue and cost of gas is reflected in Staff's final revenue requirement. (ICC Staff Ex. 1.0, Sch. 1.1 Gas.)

b. Reclassification of Cost of Allocated Water Supply- *Water*

In Direct Testimony, Staff witness Smith proposed an adjustment to reclassify revenue intended to recover the cost of water allocated from WPL. Because the Company will purchase water from the City of Beloit in the future, rather than from WPL,

and recover the cost of the purchased water through a rider, the revenue is appropriately separated from base revenues. This adjustment has no impact on net income. (ICC Staff Ex. 3.0, p. 9 and Schedule 3.1) The Company has not challenged this adjustment.

c. Source of Water Adjustment – *Water*

Given that in the future the cost of water will be recovered through a rider, Mr. Smith proposed an adjustment to increase the amount of water revenue to equal the cost of purchased water in the Company's revenue requirement. Because the cost of water will be recovered separately from base rates, the cost of water is properly excluded from rates to be developed in this Docket. (ICC Staff Ex. 3.0, pp. 9-10 and Schedule 3.2.) The Company has not contested this adjustment and it is appropriately made.

2. Expenses- *Gas & Water*

a. Interest Synchronization- *Gas & Water*

The Company agreed with Staff's proposed adjustments to Interest Synchronization in the rebuttal testimony of Martin W. Seitz. (Company Ex. MWS-2 Gas & Water, p. 2 of 10, lines 11 – 16)

Schedules 1.5 compute the interest component of Revenue Requirement. The Interest Expense (component) is computed by multiplying the Rate Base by Weighted Cost of Debt. The calculated Interest Expense is then compared against the Interest Expense used by the Company in its computation of test year Income Tax Expense. The tax effect of the difference in Interest Expense is the adjustment for Interest

Synchronization. The effect of this adjustment is to ensure that the Revenue Requirement reflects the tax savings generated by the interest component of Revenue Requirement.

There is no contested issue for the Commission to make a decision on regarding Staff's adjustment to Interest Synchronization because the Company agreed with Staff's adjustment in the rebuttal testimony of Martin W. Seitz. (Company Ex. MWS-2 Gas & Water, p. 2 of 10, lines 11 – 16)

b. Uncollectible Accounts Expense- *Gas & Water*

Staff witness Jones proposed an adjustment to decrease uncollectible accounts expense ("uncollectibles") by applying the uncollectibles rate as presented by the Company in the calculation of its Gross Revenue Conversion Factor to test year revenues. (ICC Staff Ex. 2.0, Sch. 2.1 Gas & 2.1 Water) The adjustment was accepted by the Company. (Company Ex. MWS-2, p. 2.)

Staff's uncontested adjustment to uncollectible accounts expense is reflected in Staff's final revenue requirement. (ICC Staff Ex. 1.0, Sch. 1.1 Gas & 1.1 Water)

c. Amortization of Rate Case Expense- *Gas & Water*

Staff witness Jones proposed an adjustment to rate case expense to change the amortization period from three years as proposed by the Company to five years. (ICC Staff Ex. 2.0, Sch. 2.2 Gas & 2.2 Water) The adjustment was accepted by the Company. (Company Ex. MWS-2, p. 2)

Staff's uncontested adjustment regarding the amortization period for rate case expense is reflected in Staff's final revenue requirement. (ICC Staff Ex. 1.0, Sch. 1.1 Gas & 1.1 Water)

d. Taxes Other than Income- *Gas & Water*

Staff witness Jones proposed an adjustment to Taxes Other Than Income to 1) remove electric distribution tax from allocated invested capital tax expense, 2) reduce allocated invested capital tax expense to the amount actually paid, and 3) correct the allocation of Illinois Utility Taxes. (ICC Staff Ex. 2.0, Sch. 2.3 Gas & 2.3 Water) The adjustment was accepted by the Company. (Company Ex. MWS-2, p. 2)

Staff's uncontested adjustment to Taxes Other Than Income is reflected in Staff's final revenue requirement. (ICC Staff Ex. 1.0, Sch. 1.1 Gas & 1.1 Water)

e. Operating Expense True-Up- *Gas*

Staff witness Jones proposed an adjustment to correct the Company's pro forma true-up adjustment to operating expenses. (ICC Staff Ex. 2.0, Sch. 2.4 Gas) The Company failed to reflect total booked costs, as required by the terms of its gas contract with WPL, in the true-up adjustment. Staff's adjustment was accepted by the Company. (Company Ex. MWS-2, p. 2)

Staff's uncontested adjustment to operating expense is reflected in Staff's final revenue requirement. (ICC Staff Ex. 1.0, Sch. 1.1 Gas)

f. PGA Revenue and Cost of Gas- *Gas*

See brief at D.1.a.

g. Savings Sharing Expense- *Gas*

In its direct testimony, the Company proposed an adjustment to eliminate a one-time shared savings expense from the test year and to replace it with an amount of expense that represents one-third of the cost to the Company of the actual savings sharing program from 1998 to 2002. (Company Ex. MWS-1, pp. 13-14) Staff does not oppose the adjustment to remove the one-time expense, but it does oppose the adjustment to include amortization of past costs in operating income.

"The Shared Savings Program is a program in which SBWGE assists commercial, industrial and agricultural customers in assessing the energy efficiency of equipment and other infrastructure that affects energy consumption." Shared savings is available only to non-residential customers. (Company Ex. JO-1, p 2.) "These projects are financed by SBWGE and the customer (participant) is charged an interest rate that is lower than the pre-tax weighted cost of capital to SBWGE." The present value of the difference between the Company's cost of capital and the interest rate paid by the participant is the cost that the Company is requesting be recovered through its proposed amortization process. (Company Ex. MWS-1, p 13)

There is no dispute regarding the facts of the savings sharing process; however, Staff witness Smith proposes that the cost of the program to SBWEG should not be recovered from the Company's customers but rather from the participants in the program. (ICC Staff Ex. 9.0, p. 19)

In direct testimony, Mr. Smith noted that the savings sharing program benefited only select commercial and industrial customers and that it is unfair to ask that the entire customer base subsidize the select few who receive the direct benefits of the

cost. (ICC Staff Ex. 3.0, p. 11) Mr. Smith also expressed concern that the Company's proposal to recover previously incurred expenses would in effect create a surcharge rider for the shared savings program. This is because the previously incurred costs would be compared against future recoveries of shared savings cost and would then be adjusted to reflect under or over recoveries. (ICC Staff Ex. 3.0, p. 12)

In rebuttal testimony the Company argued that its proposal was proper because it properly accounted for the Shared Savings cost and because the program offered societal benefits and general benefits to all customers. More specifically, Mr. Seitz suggested that it is proper to include deferred cost in revenue requirements intended to recover the cost of future operations. (Company Ex MWS-2, p. 8) As refuted by Mr. Smith, the fallacy of this argument is axiomatic. Rates intended to recover costs of future operations should by definition exclude costs incurred for past operations. (ICC Staff Ex. 9.0, p. 6) Mr. Seitz cites coal tar expenses and rate case expenses as examples of past costs that can be recovered in future rates. (Company Ex. MWS-2, p. 9) Mr. Smith points out that neither of these examples is consistent with the shared savings cost. Coal tar costs are recovered through a rider and are mandated by law, whereas, the savings sharing program is purely optional and clearly not appropriate for recovery through base rates. While rate case expense is traditionally "amortized" in revenue requirement, the process is in reality normalization. When considering rate case expense, the known or anticipated amount of expense is divided by the expected length of time until the utility files its next rate case. Consequently, while the term amortization might be used, in reality future rate case expense is spread over a number of years so that expense for the test year reflects the fact that the utility does not incur

rate case expense every year. Thus, the Company's example of rate case expense is inconsistent with and irrelevant to the proposal to include deferred shared savings cost in revenue requirement. (ICC Staff Ex. 9.0, p. 7)

In an effort to reassure the Commission, in rebuttal testimony, the Company suggests that the recovery of shared savings cost from customers through revenues could be reconciled with the costs included in previous rate cases. (Company Ex. MWS-2, p. 9) What the Company is proposing is that a surcharge be embedded in base rates and that a reconciliation occur when rate cases are filed. The very reason for coal tar, purchased gas, and similar riders is that base rates, while constructed initially from specific costs lose the identity of those costs when charged to customers. Rates that are charged to customers are neither separated, nor separable, into their individual components. In order to reconcile savings sharing costs with revenues, various assumptions would need to be made resulting in an exercise of single-issue rate making. (ICC Staff Ex. 9.0, p. 8)

While Company witness Carlson provides several specific arguments in support of his position, it all boils down to a belief that all customers, and even all of society, benefit when a few customers reduce their energy consumption. (Company Ex. JO-2, p 9) However, it is unreasonable to expect that all customers should pay the interest cost on behalf of participant customers who buy equipment that saves the participant gas cost.

In his rebuttal testimony, Mr. Carlson cites the Order in ICC Docket 88-0199 as approving a plan that is similar to the Shared Savings Program at issue in this Docket, and argues that that Order is precedent for the recovery of shared savings costs in this

Docket. However the Order in Docket 88-0199 states, “IT IS FURTHER ORDERED that nothing in this Order shall be construed as a determination that the costs incurred in implementing these programs will automatically found to be (sic) reasonable for inclusion as expenses in Petitioner’s next rate proceeding,” and controverts any precedent value that it might otherwise have.

In rebuttal testimony, Mr. Carlson argued that the savings sharing program is consistent with Commission policy. (Company Ex. JO-2, p. 3) However, no specific policy was cited and Mr. Smith noted that based upon broad policy, one set of customers should not subsidize another set of customers. It is not reasonable to expect the non-participants to pay cost that will create benefits specifically for the participants. (ICC Staff Ex. 9.0, p 10)

Mr. Carlson continues to argue that because the saved sharing plan results in reduced gas consumption for the participants, system peak consumption will be reduced and gas cost to all customers will be reduced. (Company Ex. JO-2, p. 4) In his rebuttal testimony, Mr. Smith notes that many factors can contribute to a reduction in peak demand. (ICC Staff Ex. 9.0, pp. 10-11) In fact, no conclusions of any kind can be made relative to Mr. Carlson’s contention because the savings in peak demand that might have resulted from the shared savings program has not been quantified.

Throughout much of Mr. Carlson’s rebuttal testimony he emphasizes his opinion that the savings sharing program provides incidental benefits to non-participating customers and the general public. (Company Ex. JO-2, pp. 5-11) As discussed by Mr. Smith, the fact that there might be incidental benefits is irrelevant to the question of who should pay for the cost of the loans that the Company incurs as a result of the shared

savings program. Ratemaking policy requires that the customers who cause the cost should pay the cost. In this case, the participants in the program incur the cost of the loans because they want to reduce the amount of gas, and associated gas cost, that they use. It is reasonable that the participants in the program pay the cost of the loans that provide them with the benefit of reduced gas cost. (ICC Staff Ex. 9.0, pp. 11-14)

The Company suggests that the denial of recovery of the cost of the savings sharing program "…would constitute penalizing SBWGE…". (Company Ex. JO-2, p. 7) However, as Mr. Smith noted, the Company has never been granted authority to recover the cost of shared savings and the Order in ICC Docket 88-0199 clearly indicates that the recovery of shared savings is not a settled issue. (ICC Staff Ex. 9.0, p. 15) While the Company might disagree with Staff's position, any suggestion that it is being treated unfairly is without merit.

In surrebuttal testimony, Mr. Seitz argues that the Company is seeking to recover future costs, not deferred costs. (Company Ex. MWS-3.0, pp. 6-9) This position is inconsistent when compared with previous testimony. In Direct testimony, the Company claims that it wants to recover cost incurred from 1998 through 2002. (Company Ex. MWS-1, pp. 13-14). The Company also argues that the inclusion of deferred costs in revenue requirement is proper. (Company Ex. MWS-2, p. 8) The Company has argued that "(d)isallowing the expenses incurred thus far would constitute penalizing SBWGE for delivering a popular and beneficial program." (Company Ex. JO-2, p. 7) During cross-examination Mr. Seitz agreed the costs for which the Company is seeking recovery date all the way to the mid 90s. (Tr. 56) While the question of whether the cost is a deferred cost or a future cost is secondary to the more important issue of who

incurs the cost, any suggestion in surrebuttal testimony that the shared savings cost that the Company seeks to recover is not a deferred cost, should be ignored.

Mr. Carlson's surrebuttal testimony tends to focus on rate design principles and the concept that some subsidies will always exist because costs are developed for customer classes rather than individual customers. Using this foundation, he states, "(w)ith Mr. Smith's reasoning, you would have to allocate costs of service to individual customers in order to be equitable, and eliminate all subsidies among customers." (Company Ex. JO-3, p. 4) Whether knowing it or not, Mr. Carlson has solved the problem. While it may not be possible to eliminate all subsidies, in this case the Commission can eliminate one subsidy if the participants are charged for the full cost of the loans, rather than allocating a portion of the cost to non-participating customers.

The issue of who should pay for loans that are incurred for the participants of the shared savings program is actually quite simple. The participants in the program receive the benefit of reduced gas costs. The participants should pay the cost of the loans that provide the benefits. There is no reason to involve the non—participating customers in this equation. For reasons discussed in this Brief, the inclusion of the shared savings cost in revenue requirement should be denied.

h. Customer Accounts Expense- *Water*

Staff witness Jones proposed an adjustment to increase the amount of customer accounts miscellaneous expenses that the Company removed from test year expense. (ICC Staff Ex. 2.0, Sch. 2.4 Water) The Company had inadvertently failed to include an allocated charge from WPL in its pro forma adjustment to reflect the terms of the

proposed water contract with WPL. The adjustment was accepted by the Company. (Company Ex. MWS-2, p. 2)

Staff's uncontested adjustment to customer accounts miscellaneous expense is reflected in Staff's final revenue requirement. (ICC Staff Ex. 1.0, Sch. 1.1 Water)

i. Interest Expense Related to Customer Deposits- *Water*

The Company agreed with Staff's proposed adjustments to Interest Expense Related to Customer Deposits - Water in the rebuttal testimony of Martin W. Seitz. (Company Ex. MWS-2 Water, p. 2 of 10, lines 11 – 16)

Schedule 1.9 presents Staff's adjustment to reflect the Company's test year interest expense on customer deposits and the related interest expense that would have accrued. In its response to data request AD-008 the Company stated that no interest is accrued while deposits are held. Instead, interest is calculated at the time of refund. Therefore, Staff proposed an adjustment to increase test year water operating expense to reflect interest expense on customer deposits using the current rate of interest approved by the Commission in Docket No. 03-0764.

There is no contested issue for the Commission to make a decision on regarding Staff's adjustment to Interest Expense Related to Customer Deposits because the Company agreed with Staff's adjustment in the rebuttal testimony of Martin W. Seitz. (Company Ex. MWS-2 Water, p. 2 of 10, lines 11 – 16)

E. Cost of Capital- *Gas & Water*

Three witnesses submitted testimony regarding SBWGE's cost of capital. Mr. Enrique Bacalao presented the Company's analysis of the cost of equity. (Company Ex.

EB-1) Mr. Martin Seitz presented the Company's analysis of the capital structure and weighted average cost of capital ("WACC"). (Company Ex. MWS-1, Schedule D-1) Ms. Janis Freetly presented Staff's analysis of SBWGE's cost of equity, capital structure, and WACC. (ICC Staff Ex. 4.0)

The Company and Staff did not reach an agreement on the appropriate cost of equity for SBWGE. The Company did not object to Staff's proposed capital structure or costs of short-term debt, long-term debt, and preferred stock for the gas and water operations of SBWGE.

1. Capital Structure- *Gas & Water*

Company witness Seitz presented the Company's proposed capital structure for the gas and water operations of SBWGE in Schedule D-1. He recommended adopting WPL's December 31, 2002 capital structure consisting of $57,354,833 of short-term debt (4.30%), $535,783,849 of long-term debt (40.17%), $59,963,000 of preferred stock (4.50%), and $680,603,006 of common equity (51.03%).

Ms. Freetly adjusted the Company's proposed short-term debt balance to reflect the average monthly balance for the twelve months surrounding the December 31, 2002 measurement date (i.e., July 2002 through June 2003). To calculate the balance of short-term debt, she first calculated the monthly ending net balance of short-term debt outstanding each month in accordance with 83 Ill. Adm. Code 285.4020. Next, she calculated twelve monthly averages from the monthly ending net balances of short-term debt. Finally, the average of the twelve monthly average net balances of short-term debt for July 2002 through June 2003 was computed. (ICC Staff Ex. 4.0, pp. 4-5 and Schedule 4.02)

Staff witness Freetly adjusted the balance of long-term debt to reflect the balances of unamortized discount and issue expense resulting from straight-line amortization of the original amount from WPL's FERC Form 1. (ICC Staff Ex. 4.0, pp. 11-12 and Schedule 4.03) She also adjusted the balance of preferred stock by adding the unamortized premium on preferred stock, which she also subtracted from the balance of common equity. (ICC Staff Ex. 4.0, pp. 5-6 and Schedule 4.04) Ms. Freetly further adjusted the balance of common equity by correcting the deductions the Company made to eliminate WPL's non-utility investments. (ICC Staff Ex. 4.0, pp. 5-6)

As a result of her adjustments to the balances of short-term debt, long-term debt, preferred stock and common equity, Ms. Freetly recommended a capital structure comprised of $33,164,078 of short-term debt (2.58%), $509,794,069 of long-term debt (39.73%), $60,218,000 of preferred stock (4.69%), and $680,073,615 of common equity (53.00%). The Company did not object to Staff's proposed capital structure. (Company Ex. MWS-2, p. 2)

2. Cost of Short-Term Debt- *Gas & Water*

The Company proposed a 1.84% cost of short-term debt, based on the weighted average interest rate actually paid over the year ended December 31, 2002. (Company Ex. MWS-2, Schedule D-2) Staff adjusted the cost of short-term debt to reflect current rates, which resulted in a 1.00% proposed cost of short-term debt. (ICC Staff Ex. 4.0, p. 10-11) The Company did not object to Staff's proposed cost of short-term debt. (Company Ex. MWS-2, p. 2)

3. Cost of Long-Term Debt- *Gas & Water*

The Company proposed a cost of long-term debt of 6.95%. (Company Ex. MWS-2, Schedule D-3) Staff adjusted the annualized amortization of debt discount and issue expense to reflect straight-line amortization of the respective unamortized balances over the remaining life of each issue. Staff also updated the interest rate on variable rate long-term debt to current rates. These adjustments resulted in a proposed cost of long-term debt of 7.30%. (ICC Staff Ex. 4.0, pp. 11-12 and Schedule 4.03) The Company did not object to Staff's proposed cost of long-term debt. (Company Ex. MWS-2, p. 2)

4. Cost of Preferred Stock- *Gas & Water*

SBWGE proposed a 5.52% cost of preferred stock. (Company Ex. MWS-2, Schedule D-4) Staff's recommendation for the embedded cost of preferred stock is 5.50%. Including the premium on capital stock in the balance of preferred stock resulted in a slightly lower cost than SBWGE presented. (ICC Staff Ex. 4.0, p. 12, Schedule 4.04) The Company did not object to Staff's proposed cost of preferred stock. (Company Ex.MWS-2, p. 2)

5. Cost of Common Equity- *Gas & Water*

a. Company Analysis & Recommendation- *Gas & Water*

Mr. Bacalao measured SBWGE's investor required rate of return on common equity with a historical and forecasted comparable earnings model, the Capital Asset Pricing Model ("CAPM"), a discounted cash flow ("DCF") model, and a risk premium model, . (Company Ex. EB-1 Gas and EB-1 Water) He applied each model to a sample developed from Value Line's 1700-company universe. He selected those companies with a Value Line safety rank of 2 and an Standard and Poor's ("S&P") long-

term corporate credit rating of A-. Since SBWGE and WPL do not have Value Line safety ranks, Mr. Bacalao used the safety rank of Alliant Energy Corporation ("Alliant"), the ultimate parent company. He relied on the current A- S&P rating for WPL. This screening resulted in a 23-company sample. Of those 23 companies, those that were missing any relevant data needed for a particular model were eliminated from the calculations for that respective model. (Company Ex. EB-1 Gas and EB-1 Water, pp. 16-17)

Mr. Bacalao's historical return on equity ("ROE") model relied on the actual returns on book equity achieved during the period from 1992 to 2001 as reported by Value Line. The average historical ROE for the sample companies is 14.02%. (Company Ex. EB-1 Gas and EB-1 Water, p. 18) Mr. Bacalao's forecasted ROE model used the forecasted returns on book equity from 2002 to 2007 as reported by Value Line. The average forecasted ROE for the sample companies is 13.85%. (Company Ex. EB-1 Gas and EB-1 Water, p. 18)

For his CAPM analysis, Mr. Bacalao first removed the effect of financial leverage from his sample companies' Value Line betas using market-value capital structures to obtain an unlevered beta and then re-levered it to reflect WPL's market-value capital structure. The average re-levered beta of his sample is 0.94. (Company Ex. EB-1 Gas and EB-1 Water, pp. 18-19) He then calculated two estimates using the CAPM, both of which incorporate the re-levered beta of 0.94 and a forecasted 30-year United States Treasury –bond ("T-bond") yield of 5.70% as an estimate of the risk-free rate. In the first CAPM calculation, Mr. Bacalao set the expected market return to 12.70%, which is based on the arithmetic mean return of the large company stocks over the period from

1926 to 2001 as published by Ibbotson Associates. The first CAPM calculates a 12.27% expected cost of equity. (Company Ex. EB-1 Gas and EB-1 Water, pp. 19-20) Mr. Bacalao's second CAPM calculation used an equity risk premium of 7.40%,[1] based on the long-horizon expected equity risk premium for large company stocks published by Ibbotson Associates. The second CAPM calculates a 12.65% expected cost of equity. The average of Mr. Bacalao's two CAPM calculations equals 12.46%. (Company Ex. EB-1 Gas and EB-1 Water, pp. 20)

Mr. Bacalao implemented an annual two-stage DCF analysis. For the first stage, he used Zack's five-year growth rate estimates. For the second stage growth rate, Mr. Bacalao used a terminal annual growth rate of 7.979% to represent the long-run nominal gross domestic product ("GDP") growth rate of the economy. This terminal growth rate is based on nominal GDP growth over the 1970-2002 period. He used the stock prices of his sample companies as of February 14, 2003. Mr. Bacalao's average cost of equity using the DCF model is 12.32%. (Company Ex. EB-1 Gas and EB-1 Water, pp. 20-21)

Mr. Bacalao's risk premium model bases its cost of equity calculation on a risk-free rate and equity risk premium using three investment horizons: long, intermediate, and short. In the long-horizon calculation, the 2004 expected 30-year T-bond yield of 5.70% is used to represent the risk-free rate. In the intermediate-horizon calculation, the expected 10-year T-bond yield of 4.95% is used to represent the risk-free. In the short-horizon calculation, the expected 1-year T-bill yield of 2.70% is used to represent the risk-free rate. The long, intermediate, and short-horizon expected equity risk

[1] Under Mr. Bacalao's second CAPM calculation, the implied rate of return on the market equals 13.1% (i.e., 5.7% risk-free rate + 7.4% market risk premium).

premiums that he used were 7.40%, 7.80%, and 8.80%, respectively. The average expected return on equity estimate calculated under this risk premium model was 12.45%. (Company Ex. EB-1 Gas and EB-1 Water, pp. 21-22)

From the five models used by Mr. Bacalao, he calculated two mid-point cost of equity estimates. The first midpoint of 12.41% is the average of the CAPM, DCF, and risk premium models. The second midpoint of 13.02% is the average of all five models: historical ROE, forecasted ROE, CAPM, DCF, and risk premium. Mr. Bacalao's final cost of equity recommendation for the gas and water operations of 12.71% is the average of those two midpoints. (Company Ex. EB-1 Gas and EB-1 Water, p. 24)

b. Staff Criticism of Company's Analysis- *Gas & Water*

Mr. Bacalao's analyses contain several errors that lead him to incorrectly estimate SBWGE's cost of common equity. Critical errors occur in, or are the result of, his sample, comparable earnings, risk premium, CAPM, and DCF analyses. (ICC Staff Ex. 4.0, pp. 35-45)

i. Mr. Bacalao's Sample

Mr. Bacalao's sample is not representative of the risk inherent in SBWGE's gas and water operations. The Value Line safety ranking is an imprecise measure of risk and its use as a screening technique is problematic as well. Value Line sorts its 1,700 company universe of stocks by a composite index score and then divides those 1,700 companies into five very broad segments from 1 (safest) to 5 (riskiest). Stocks that are close to one another, such as numbers 150 and 151, may be assigned different safety numbers while stocks ranked far from each other, such as number 401 and 1300, may

be assigned the same safety number. Therefore, stocks with different assigned safety numbers may be more similar in risk than stocks ranked far apart with identical assigned safety numbers.

Further, Alliant's safety rank reflects non-utility risks since Alliant's nonregulated subsidiary, Alliant Energy Resources Inc. ("Resources"), operates international distribution and generation and U.S. generation businesses. The implied safety rank of SBWGE or WPL on a stand-alone basis cannot be derived since Value Line does not reveal the degree to which Resources affects Alliant's risk. Calculating the cost of equity estimate from a sample based on Alliant's safety rank would reflect the risk of the unregulated affiliate, Resources.

In Docket Nos. 01-0528/01-0628/01-0629 Consolidated, the Commission rejected use of Value Line safety ranking in selecting a sample. (Order, Docket Nos. 01-0528/01-0628/01-0629 Consolidated, March 28, 2002, p. 12) The Commission agreed that the Value Line safety ranking can be an imprecise measure of risk and that use of Alliant's Value Line safety ranking is inappropriate because it reflects non-utility risks. In addition, the Commission rejected the inclusion of industrial companies in sample calculations in Docket No. 99-0117. (Order, Docket No. 99-0117, August 26, 1999, p. 46)

In addition, Mr. Bacalao used WPL's current S&P corporate credit rating of A-. WPL's credit rating was downgraded to A- due to Alliant's non-utility investments. On October 15, 2001, S&P downgraded WPL to A from AA-. That downgrade was a result of WPL's parent company, Alliant's "increased focus on expanding its higher-risk nonregulated businesses." (ICC Staff Ex. 4.0, p. 9) WPL was further downgraded to A-

from A on December 6, 2002 as a result of Alliant's downgrade to BBB+ from A-, which in turn was due to lower-than-expected returns from higher-risk nonregulated businesses. (ICC Staff Ex. 4.0, p. 9) On January 13, 2003, Moody's Investors Service ("Moody's") lowered the ratings for WPL to A1 from Aa2 to reflect changes in business risk resulting from Alliant's expansion of non-regulated activities. (ICC Staff Ex. 4.0, p. 9)

Ms. Freetly presented data to support her position that downgrades to Alliant's credit ratings led to a downgrade of WPL's credit ratings. ICC Staff Ex. 10.0, Schedule 10.01 shows that WPL's adjusted benchmark ratios did not reveal any significant deterioration of WPL's financial strength or increase in its financial risk during the 1997-2002 period. Further, WPL's S&P business profile score (i.e., assessment of business risk) was not altered during the period of rating downgrade for Alliant. Hence, that Alliant's investment in higher-risk nonregulated businesses caused the downgrading of WPL's credit rating remains the only tenable conclusion.

Section 9-230 of the Illinois Public Utilities Act (220 ILCS 5/9-230 *et seq*., "Act") states that:

> In determining a reasonable rate of return upon investment for any public utility in any proceeding to establish rates or charges, the Commission shall not include any (i) incremental risk, [or] (ii) increased cost of capital…, which is the direct or indirect result of the public utility's affiliation with unregulated or non-utility companies.

Section 9-230 prohibits the Commission from reflecting in SBWGE's cost of capital the risks associated with its affiliation with unregulated or non-utility companies. (Illinois Bell Telephone Co. v. Illinois Commerce Commission, 283 Ill. App. 3d 188, 207 (1996)) Therefore, basing SBWGE's allowed rate of return on the basis of WPL's A- credit rating

is not permissible under the Act since that credit rating is due to WPL's affiliation with unregulated or non-utility companies. (ICC Staff Ex. 4.0, p. 10)

By relying on Alliant's safety rank and the current credit rating of WPL in forming his sample, Mr. Bacalao's cost of equity estimates reflect the risk of Alliant's non-regulated operations. (ICC Staff Ex. 4.0, pp. 37-38) As a matter of law, this increased risk cannot be reflected in the rate of return the Commission finds reasonable for SBWGE. (220 ILCS 5/9-230) Thus, Mr. Bacalao's reliance on a sample that does not conform to the requirements of Section 9-230 is sufficient grounds for the Commission to reject his cost of common equity recommendation irrespective of the supposed validity of the cost of equity models and methods he employed. Nevertheless, Staff's Initial Brief will also show how the record demonstrates that Mr. Bacalao's cost of equity analyses are either inherently invalid (i.e., comparable earnings analysis) or implemented in a manner that produces spurious estimates of the cost of common equity (i.e., DCF model, CAPM and risk premium model).

ii. Comparable Earnings

Mr. Bacalao's comparable earnings methodology does not provide valid estimates of the investor-required rate of return on SBWGE's common equity. Mr. Bacalao used historical and forecasted estimates of return on book equity for the companies in his samples to estimate SBWGE's cost of equity. He claims that actual book returns provide a less biased view of return levels. (Company Ex. EB-1 Gas and EB-1 Water, p. 17) The comparable earnings approach is badly flawed. The cost of common equity is the market-required rate of return demanded by investors. In contrast, comparable earnings analysis is an accounting return-based methodology

rather than a market-based methodology. The comparable earnings method incorrectly implies that the earned or expected rates of return on book common equity are equivalent to the current investor-required rate of return. However, there is simply no basis for this implication. Market-based cost of equity methodologies reflect the investor-required rate of return since the market price of a common stock will not reach equilibrium until the expected rate of return on the common stock equals the investor-required rate of return. In contrast, the return on book equity has no such adjustment mechanism since its denominator, book value, is largely unresponsive to market forces. (ICC Staff Ex. 4.0, pp. 39-40)

Mr. Bacalao imbues relevance in the fact that the authorized rate of return established for rate case purposes will be based on accounting-based book value. (Company Ex. EB-23, p. 10; Company Ex. EB-24, p. 9) Ms. Freetly agreed that to establish utility rates, regulators apply a market-based rate of return to a book value rate base. (ICC Staff Ex. 10.0, p. 10) Nevertheless, the current investor-required rate of return is necessary for determining the rate of return on equity. Investor rate of return requirements are a function of risk and manifested in the market prices of securities. Due to unanticipated events, (e.g., lower than expected sales levels, higher than expected capital expenditures, and lower than expected inflation) a company's accounting rate of return is unlikely to equal the rate of return that investors require. If investors expect to realize a rate of return in excess of their requirements, they will bid up the price of the company's stock until the expected rate of return on that stock price equals the rate of return investors require in exchange for bearing the risk associated with that stock. Conversely, if investors expect to realize a rate of return below their

requirements, they will bid down the price of a company's stock until the expected rate of return on that stock price equals the rate of return that investors require. (ICC Staff Ex. 10.0, pp. 10-11)

Mr. Bacalao claimed that book values are not immune to market forces, since they are subject to periodic mechanisms that test whether book values have been impaired. (Company Ex. EB-23, p. 10) Although asset book values are periodically tested for impairment, those impairment tests are not equivalent to the continual reassessments of value that take place in the financial marketplace. First, book values are not revised upward to reflect increasing value unless the underlying assets are sold. Second, a reduction (i.e., impairments) in the value of a tangible, long-lived asset is recognized only if that book value exceeds the undiscounted value of its future cash flows from those assets.[2] In contrast, market value is based on discounted future cash flows. Therefore, accounting book values are unresponsive to market forces. If book values were responsive to market forces, book and market values would equal. (ICC Staff Ex. 10.0, pp. 11-12)

In addition, accounting practices can distort significantly the rates of return used in comparable earnings analysis. Accounting returns between two companies may not be directly comparable, particularly if those companies are from different industries. Differences in accounting practices can have a significant impact on accounting rate of return. The sample group used by Mr. Bacalao for his comparable earnings analysis

[2] Mr. Bacalao argued that impairment tests use discounted future cash flows, not undiscounted cash flows. (Company Ex. EB-24, pp. 9-10) However, Company witness Seitz agreed that according to the Financial Accounting Standards Board's Statement of Financial Accounting Standards 144, the carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset. (Tr. 65, lines 4-15)

included industrial companies, which do not follow the same accounting rules as regulated utilities. (ICC Staff Ex. 10.0, p. 11)

The Commission rejected use of the comparable earnings methodology in several proceedings, including Docket Nos. 01-0528/01-0628/01-0629 Consolidated, 99-0121, 92-0448/93-0239 Consolidated, and 89-0033.[3] (ICC Staff Ex. 4.0, p. 41) The Company's arguments do not justify a reversal of this long-held Commission position.

iii. Risk Premium Model

Mr. Bacalao's risk premium model is based on the incorrect assumption that historical risk premiums are reasonable estimates of current investor-required risk premiums. Mr. Bacalao relied upon historical risk premiums in his risk premium analysis. Historical risk premiums do not adequately measure investors' current return requirements because historical risk premiums are based on realized returns. Due to unpredictable movements in financial markets and the economy, the difference between realized and expected returns can be substantial. Thus, historical premiums are not reliable proxies for current or future risk premiums. (ICC Staff Ex. 4.0, p. 41)

Mr. Bacalao contended that examining a long period of time would result in a more normalized sense of what an investor can expect because it will include a number of business cycles and major exogenous events of varying durations and intensities. (Company Ex. EB-23, p. 11) Nevertheless, the use of historical data remains problematic. Historical data improperly favors outdated information that the market no longer considers relevant over the most-recently available information. Historical data

[3] Order, Docket Nos. 01-0528/01-0628/01-0629 Consolidated, March 28, 2002, p. 13; Order, Docket 99-0121, August 25, 1999, p. 68; Order, Docket No. 92-0448/93-0239 Consol., October 11, 1994, p. 173; Order on Remand, Docket No. 89-0033, November 4, 1991, p. 15.

reflects (1) conditions that may not exist in the future; and, (2) the market's response to those conditions, which may not be repeated in the future. (ICC Staff Ex. 10.0, p. 12)

The Commission has previously ruled against the use of historical stock return data in determining a company's cost of equity. In Docket No. 92-0357, a rate proceeding for Iowa-Illinois Gas and Electric Company, the Commission Order stated, "[t]he Commission notes that the investor-required return on common equity is a forward-looking concept. Mr. Benore [the company witness], in many instances, inappropriately utilized historical data to determine the Company's cost of equity."[4] Similarly, in Docket No. 95-0076, a rate proceeding for Illinois-American Water Company, the Commission Order stated, "[t]he Commission also concludes that Staff's criticism of Dr. Phillips' use of two-month average historical stock prices and historical growth rates in his traditional DCF analysis, and historical risk premiums in his risk premium analysis are valid. Historical data is inappropriate in determining a forward-looking cost of equity because it contains information that may no longer be relevant to investors."[5] (ICC Staff Ex. 4.0, pp. 41-42)

Furthermore, Mr. Bacalao did not demonstrate that the risk premiums he used were appropriate for SBWGE. Since he did not adjust the results of his risk premium model for risk, the risk premium model used by Mr. Bacalao implies that SBWGE is as risky as the market as a whole, a proposition that he did not support and the evidence from the other models he used contradicts. For example, the beta estimate employed by Mr. Bacalao in his CAPM analysis indicates that his sample, allegedly equivalent to SBWGE in risk, is less volatile than the overall market. In addition, the cost of equity

[4] Order, Docket No. 92-0357, July 21, 1993, p. 66.
[5] Order, Docket No. 95-0076, December 20, 1995, p. 70.

estimates resulting from Mr. Bacalao's DCF analysis indicate its cost of equity is lower than the cost of common equity for the market as a whole.

iv. CAPM Analysis

Mr. Bacalao's CAPM contains an unwarranted leverage adjustment. Mr. Bacalao modified the beta component of the CAPM to account for the effect of a company's financial leverage on its risk. Mr. Bacalao unlevered the beta estimates of his sample companies using market-value capital structures and then re-levered them based on an estimated market-value capital structure of WPL. He then used the re-levered betas for his sample companies when estimating the cost of equity with the CAPM methodology. (Company Ex. EB-1 Gas and EB-1 Water, pp. 18-19) Financial leverage is the amount of debt in relation to the amount of equity in a firm's capital structure. The greater the proportion of debt to equity, the greater the financial leverage, and thereby the greater the financial risk. (Tr. 99, lines 5-14) Re-levering the betas of his sample companies to SBWGE's financial leverage increases the implied risk of Mr. Bacalao's sample relative to SBWGE. The beta for his entire sample averages 0.75 and the re-levered beta averages 0.94, indicating that the financial risk of the sample is lower than that of SBWGE. Therefore, if the sample had the same total risk as SBWGE but lower financial risk (before the beta adjustment) the operating risk of the entire sample must be higher. Thus, the leverage adjustment might result in a sample with the same financial risk as SBWGE, but operating risk would remain higher. Explicitly, if the total risk of Mr. Bacalao's sample was equal to that of SBWGE, then his beta adjustment resulted in a sample with implied total risk greater than that for SBWGE. (ICC Staff Ex. 4.0, pp. 42-43)

The Commission rejected use of the leverage adjustments in Docket Nos. 01-0528/01-0628/01-0629 Consolidated, 99-0120/99-0134 Consolidated, and 94-0065.[6]

Mr. Bacalao contended that a leverage adjustment is necessary in order to compare the betas of his sample companies to WPL on an apples-to-apples basis. (Company Ex. EB-23, pp. 11-12) However, the leverage adjustment actually results in an apples-to-oranges comparison. Ignoring the question of whether Alliant is an appropriate proxy for WPL, Mr. Bacalao's risk measures, Value Line safety rank and S&P credit ratings are supposed to assist identification of companies that are comparable in risk to WPL. Both Value Line safety rank and S&P credit ratings reflect both operating risk and financial risk. By re-levering the betas of the sample companies to WPL's leverage, Mr. Bacalao increased the implied financial risk of his sample relative to WPL, such that if his sample were equal in total (i.e., operating + financial) risk to WPL before the leverage adjustment, the total risk of his sample must be greater in risk to WPL after the leverage adjustment. During cross-examination, Mr. Bacalao agreed that if financial risk increases and operating risk remains constant, total risk would also increase. (Tr. 99, lines 5-14) Thus, the leverage adjustment results in an apples-to-oranges comparison. (ICC Staff Ex. 10.0, p. 13)

v. DCF Analysis

Mr. Bacalao's DCF analysis contains an unreasonable terminal growth rate. For the reasons previously discussed, it is inappropriate to rely on historical earnings data in determining a forward-looking cost of equity. The second stage growth rate should be an estimate of expected long-term economic growth. In addition, Mr. Bacalao's nominal

[6] Order, Docket Nos. 01-0528/01-0628/01-0629 Consolidated, March 28, 2002, pp. 12-13; Order 99-0120/99-0134 Consol., August 25, 1999, p. 54; Order 94-0065, January 9, 1995, pp. 92-93.

GDP growth estimate incorporates both inflation and GDP growth. U.S. Treasury bond yields incorporate inflation and GDP growth, plus a risk premium. Mr. Bacalao's estimate is in excess of the yields on U.S. Treasury bonds of all maturities, which indicates that his terminal growth rate is excessive. (ICC Staff Ex. 4.0, pp. 44-45)

Mr. Bacalao asserts that the object of looking at a longer time period is to establish a realistic level of GDP growth and that there is more confidence and comfort in using a known and measurable rate of growth than there is in relying on estimates that are more colored by the recent past and the issues of the day. (Company Ex. EB-23, p. 12) However, Mr. Bacalao did not examine the rate of growth in earnings of dividends of the utility sector over the 1970-2002 period on which his terminal growth rate is based in determining its reasonableness as a proxy for long-term growth for a utility. (Tr. 98, lines 4-13)

A comparison of the terminal growth rate used by Mr. Bacalao to U.S. Treasury bond yields and forecasted growth in nominal GDP illustrates the unreasonableness of his second stage growth rate of 7.979%. Thirty-year U.S. Treasury bonds are yielding 5.12%. Forecasts of nominal GDP project growth of 6.0% over the 2003 through 2028 period. Estimating a second stage growth rate is problematic since company specific long-term growth forecasts are not available. Applying the same growth rate to all of the sample companies assumes that all of the companies are going to converge to the same rate of return on common equity and that all of the companies payout the same proportion of earnings as dividends. This is highly unlikely given the disparity in the sample companies used by Mr. Bacalao. It is also a flawed assumption to presume that utilities will grow at the same rate as the economy due to the maturity of the utility

industry and the higher dividend payout of utility companies in comparison to the overall market. (ICC Staff Ex. 10.0, pp. 13-14)

The sustainable growth model illustrates the relationship between dividend payout and growth. This model states that growth is the product of the retention ratio (b) and the expected return on equity (r), (i.e. g = b x r). Thus, all else equal, an increase in the retention ratio will produce a higher sustainable growth rate. However, the dividend payout ratio equals one minus the retention ratio. Therefore, while an increase in the retention ratio increases sustainable growth, it systematically decreases the dividend payout ratio and, consequently, the dividend yield. In other words, according to the sustainable growth model, companies with higher dividend payout ratios have lower growth rates, all else equal. (Tr. 97, lines 15-19) Given the inverse relationship between growth and dividend yields, one would expect utilities to have lower growth rates than average because of their higher than average dividend yields (utilities payout more dividends and thereby have lower retention ratios). In fact, the average long-term projected growth rates of 4.70%, 6.69%, and 4.18% for Ms. Freetly's gas, water, and utility samples, respectively, are lower than the long-term projected growth of 8.17% for the S&P 500. In addition, the current dividend yields of 4.03%, 2.63%, and 4.09% for Ms. Freetly's gas, water, and utility samples, respectively, are higher than the 1.60% dividend yield for the S&P 500. Thus, given the lower growth rates and higher dividend yields of utilities, it is not reasonable to assume that all of the sample companies will grow at the 7.979% rate, as assumed by Mr. Bacalao. (ICC Staff Ex. 10.0, pp. 13-15)

c. Staff's Analysis & Recommendation- *Gas & Water*

Staff witness Janis Freetly measured the investor-required rate of return on common equity for SBWGE's gas and water operations with the discounted cash flow ("DCF") and risk premium models. Since SBWGE does not have market-traded common stock, DCF and risk premium models cannot be applied directly to SBWGE; therefore, Ms. Freetly applied both models to samples of natural gas distribution companies, water utilities, and public utilities comparable in risk to SBGWE's corporate parent, WPL.

Ms. Freetly's gas sample comprises nine dividend-paying, market-traded gas utilities from the *Standard & Poor's Utility Compustat* database that had S&P credit ratings of AA to A-; S&P business profile scores of 2, 3, or 4; and long-term growth rate estimates from Zacks Investment Research ("Zacks") or Institutional Brokers Estimate System ("IBES"). (ICC Staff Ex. 4.0, p. 13) Ms. Freetly's water sample comprises seven dividend-paying, market-traded water utilities within the *S&P Utility Compustat* database that had long-term growth rate estimates from Zacks or IBES. (ICC Staff Ex. 4.0, pp. 13-14) The utility sample comprises eight dividend-paying, market-traded utilities within the *S&P Utility Compustat* database that had a S&P business profile score of 3; S&P credit ratings of AA to A-; and long-term growth rate estimates from Zacks or IBES. (ICC Staff Ex. 4.0, p. 14)

i. DCF Analysis

DCF analysis assumes that the market value of common stock equals the present value of the expected stream of future dividend payments. Since a DCF model incorporates time-sensitive valuation factors, it must correctly reflect the timing of the

dividend payments that stock prices embody. The companies in Ms. Freetly's samples pay dividends quarterly; therefore, she applied a constant-growth quarterly DCF model.

Determining the market-required rate of return with the DCF methodology requires a growth rate that reflects the expectations of investors. Ms. Freetly measured the market-consensus expected growth rates with projections published by Zacks and IBES. The growth rate estimates were combined with the closing stock prices and dividend data as of February 3, 2004. Based on this growth, stock price, and dividend data, Ms. Freetly's DCF estimates of the cost of common equity were 9.40% for the gas sample, 9.78% for the water sample, and 8.98% for the utility sample. (ICC Staff Ex. 4.0, pp. 14-20 and Schedules 4.05 - 4.08)

ii. Risk Premium Analysis

The risk premium model is based on the theory that the market-required rate of return for a given security equals the risk-free rate of return plus a risk premium associated with that security. The risk premium methodology is consistent with the theory that investors are risk-averse. In equilibrium, two securities with equal quantities of risk have equal required rates of return. Ms. Freetly used the CAPM, a one-factor risk premium model, to estimate the cost of common equity. In the CAPM, the risk factor is market risk, which is defined as risk that cannot be eliminated through portfolio diversification.

To implement the CAPM, three parameters must be estimated: the risk-free rate of return; the expected rate of return on the market; and a security or portfolio-specific measure of market risk. Ms. Freetly considered two current estimates of the risk-free rate of return: the 0.94% yield on three-month U.S. Treasury bills and the 5.12% yield

on thirty-year U.S. Treasury bonds. Both estimates are derived from quotes for February 3, 2002. Forecasts of inflation and real GDP imply that the long-term risk-free rate is between 5.7% and 6.0%. Thus, Ms. Freetly concluded that the thirty-year U.S. Treasury bond yield is currently the superior proxy for the long-term risk-free rate. (ICC Staff Ex. 4.0, pp. 21-26)

Ms. Freetly estimated a 13.50% expected rate of return on the market by conducting a DCF analysis on the firms composing the S&P 500 Index. (ICC Staff Ex. 4.0, p. 27)

Beta measures risk in a portfolio context; it exemplifies a security's volatility in relation to the market. Ms. Freetly developed two distinct sample average betas for each sample, one based on the Value Line methodology ("Value Line beta") and the other based on the Merrill Lynch methodology ("Regression beta"). She used adjusted betas to estimate a forward-looking beta. (ICC Staff Ex. 4.0, p. 30) The Value Line beta estimates average 0.73 for the gas sample, 0.59 for the water sample, and 0.72 for the utility sample. The Regression beta estimates are 0.50 for the gas sample, 0.42 for the water sample, and 0.53 for the utility sample. The average of the Value Line and Regression beta estimates equals 0.62 for the gas sample, 0.51 for the water sample and 0.63 for the utility sample. (ICC Staff Ex. 4.0, pp. 27-31)

Inputting Ms. Freetly's risk-free rate, return on the market, and beta estimates into the CAPM, produces cost of common equity estimates of 10.32% for the gas sample, 9.40% for the water sample, and 10.40% for the utility sample. (ICC Staff Ex. 4.0, Schedule 4.09)

iii. Recommendation

Based on the results of her DCF and risk premium analyses, Ms. Freetly estimated that the cost of common equity for SBWGE equals 9.87% for the gas operations and 9.64% for the water operations. The average investor required rate of return on common equity for the gas operations of SBWGE, 9.87%, is based on the average of the DCF-derived results (9.40%) and the risk premium-derived results (10.32%) for the gas sample. The investor-required rate of return on common equity for the water operations of SBWGE was derived by: 1) averaging the DCF-derived estimates of the required rate of return on common equity for the water (9.78%) and utility (8.98%) samples, or 9.38%, 2) averaging the risk premium-derived estimates of the required rate of return on common equity for the water (9.40%) and utility (10.40%) samples, or 9.90%, and 3) taking the midpoint of the DCF and risk premium derived estimates, or 9.64%. (ICC Staff Ex. 4.0, pp. at 31-33)

Ms. Freetly used the average of the water and utility samples to estimate the cost of common equity for the water operations of SBWGE in order to attain a greater degree of comparability. She evaluated the S&P credit ratings, business profile scores, and the S&P benchmark ratios for each of the samples in comparison to WPL. (ICC Staff Ex. 4.0, Schedule 4.10) The three-year average benchmark ratios for the gas sample are the most similar to WPL. The three-year average benchmark ratios for the water sample are the least comparable to WPL. The three-year average benchmark ratios for the utility sample are more comparable to WPL than the water sample. Hence, Ms. Freetly used the utility sample in conjunction with the water sample to estimate the cost of equity for the water operations of SBWGE to more closely simulate the risk of WPL. Since she is estimating the cost of equity for the water operations of SBWGE, Ms.

Freetly retained the water sample because it captures industry-level operating risks associated with the provision of water service. It was not necessary to use the utility sample in combination with the gas sample, since the three-year average benchmark ratios for the gas sample were more comparable to WPL than the utility sample and better reflected the risk of WPL. (ICC Staff Ex. 4.0, p. at 34)

d. Staff Response to Company's Criticisms- *Gas & Water*

i. Samples

Mr. Bacalao criticized Ms. Freetly's sample groups because the average business profile score of the samples is 3, while WPL's business profile score is 4. (Company Ex. EB-23, pp. 7-8; Company Ex. EB-24, p. 8) He claims that the intrinsically lower risk profile of the sample groups skew the cost of equity calculations downward. Ms. Freetly limited the gas sample to gas utilities with S&P business profile scores of 2, 3, or 4 because there were only two gas utilities in S&P *Utility Compustat* with business profile scores above 4. Energen Corp. and National Fuel Gas Company both have business profile scores of 6 due to considerable investments in riskier nonregulated exploration and production subsidiaries. Hence, these companies were excluded from the sample so that the sample reflected the risk inherent in the regulated gas utility business. (ICC Staff Ex.10.0, p. 9) The purpose of the gas sample is to estimate the cost of equity of the gas operations of SBWGE. Since the average business profile score for gas utilities is 3, Ms. Freetly concluded that an average business profile of 3 for the gas sample was reasonable. (Tr. 206-208, lines 19-2) In forming the water sample, Ms. Freetly used the available universe of publicly traded water utilities. (ICC Staff Ex. 10.0, p. at 9) The companies in the utility sample were limited to those with

S&P business profile scores of 3 because that is the average business profile score of the water utility industry, which is exposed to the same sources of operating risk as the water utility operations of SBWGE. (ICC Staff Ex. 10.0, p. 9)

Mr. Bacalao further criticized Ms. Freetly's sample for being constrained to a particular sector. (Company Ex. EB-23, pp. 8-9) Ms. Freetly selected companies to include in her samples on the basis of their similarity in risk to SBWGE's water and gas operations. Although some industrial companies may be similar in risk to SBWGE, identifying such companies is problematic because SBWGE (nor WPL for that matter) does not have publicly traded common equity; hence, investment advisory services such as Value Line do not evaluate the risk of its common equity. In addition, Commission Staff does not have access to data that would enable it to quantitatively measure the risk of industrial companies. Limiting samples to companies in the same industry assures a degree of comparability in business risk that is not attainable with industrial companies given the tools at hand. S&P's business profile scores, which also measure business risk, enabled Staff to refine the comparability of the gas sample's and utility sample's business risk to that inherent in SBWGE's gas and water operations, respectively. Finally, credit ratings enabled Staff to identify companies with similar financial strength, and hence, financial risk, to SBWGE. (ICC Staff Ex. 10.0, p. 8)

ii. DCF

Mr. Bacalao noted several assumptions in the DCF model which he argued might be unreasonable. (Company Ex. EB-23, p. 3) In response, Ms. Freetly testified that the DCF model should not be judged by the strict conformance to reality of its growth rate assumption, but rather by its ability to accurately estimate the investor required rate of

return. In other words, the constant growth DCF model can accurately measure the investor-required rate of return even if future cash flows are not expected to grow at a non-varying periodic rate. Substitution of projected growth in earnings for projected growth in dividends is necessary due to the extreme scarcity of dividend forecasts. Fortunately, that substitution does not degrade cost of equity estimates since a company's ability to pay dividends, both in the present and the future, is a direct function of its earnings. That is, dividends represent a distribution of the company's earnings to its shareholders. Dividends cannot indefinitely grow faster than earnings, hence, assuming that dividend growth will equal earnings growth is reasonable. (ICC Staff Ex. 10.0, pp. 2-3)

When the dividend payout does not change, growth in dividends and growth in earnings will be equal. However, when dividend payout fluctuates, the rate of growth in dividends and earnings temporarily diverge. If a company increases its payout of dividends, dividend growth will be slower in the long-term, which offsets the temporary increase in dividend growth in the short-term. Merton Miller and Franco Modigliani (MM) argued that dividend policy has no effect on the price of a firm's stock or its cost of capital. They reasoned that the value of a firm does not depend on how earnings are split between dividends and retained earnings when investors and the company can earn the same rate of return on investments of equal risk. MM concluded that dividend payout policy will not affect the total return to a company's shareholders. Hence substituting earnings growth for dividend growth does not reduce the accuracy of DCF-based cost of common equity estimates. (ICC Staff Ex. 10.0, pp. 3-4)

The cost of common equity calculation derived from a constant-growth estimate is correct when the five-year growth rate forecast for each company in the sample is expected to equal its average long-term dividend growth. However, if the five-year growth rates projected for the companies in the sample are significantly higher than economy-wide growth, the former are unlikely to be sustained over the long-term. Therefore, a multi-stage DCF model with a long-term growth rate, consistent with projected long-term economic growth and adjusted for relative risk and dividend policy, should be used. The five-year growth rates for the companies in Ms. Freetly's samples, which average 4.70%, 6.69%, and 4.18% for the gas, water and utility samples, respectively, are reasonable in comparison to Global Insight's projected growth in nominal GDP of 6.0% over the 2003 through 2028 period. One would expect utilities to have a lower growth rate than the overall economy, since utilities have higher dividend payout ratios than the market as a whole. For example, for the twelve months ending September 30, 2003, the dividend payout ratio equaled 41% for the S&P 500 and 63% for the gas sample, 71% for the water sample, and 64% for the utility sample. Therefore, Ms. Freetly concluded that a multi-stage DCF model is unnecessary and, given the inherent difficulty in independently measuring investor expectations of long-term growth for utilities, more likely to reduce the accuracy of cost of equity estimates than increase it. (ICC Staff Ex. 10.0, pp. 4-5)

iii. CAPM

Mr. Bacalao criticized the beta values Ms. Freetly used in her risk premium analysis because they are calculated on historical correlations. (Company Ex. EB-23, p.3) Historical information must be used to ascertain the relationship between the

return on a security and the return on the market because a security's true beta, or future beta, is unobservable. Further, using historical data to calculate stock return variance does not pose the same problems as measuring the expected stock return using historical data. Estimating variance of stock returns is significantly easier than estimating mean or expected stock returns. A shorter time period can be used without sacrificing the precision of an estimate of variance, allowing the estimate to be more up-to-date and relevant. Lengthening the measurement period is the only way to increase the precision of an estimate of mean or expected stock returns. This poses a problem because by the time a high degree of precision in estimating the mean stock return from historical data has been attained, the mean itself has almost certainly shifted. (ICC Staff Ex. 10.0, pp. 5-6)

6. Overall Cost of Capital Recommendation- *Gas & Water*

Ms. Freetly's overall cost of capital recommendation, incorporating her recommended capital structure, cost of short-term debt, embedded cost of long-term debt, embedded cost of preferred stock, and cost of common equity is 8.41% for the gas operations of SBWGE and 8.29% for the water operations of SBWGE. The record demonstrates that Ms. Freetly's recommendations are based upon the valid application of sound financial theory, while Mr. Bacalao's are not. Therefore, Staff recommends that the Commission adopt Ms. Freetly's recommendations, as outlined below, to set rates in this proceeding.

Overall Cost of Capital for SBWGE Gas Operations

Capital Component	Ratio	Cost	Weighted Cost
Short-Term Debt	2.58%	1.00%	0.03%
Long-Term Debt	39.73%	7.30%	2.90%
Preferred Stock	4.69%	5.50%	0.26%
Common Equity	53.00%	9.87%	5.23%
Total	100.00%		8.41%

Overall Cost of Capital for SBWGE Water Operations

Capital Component	Ratio	Cost	Weighted Cost
Short-Term Debt	2.58%	1.00%	0.03%
Long-Term Debt	39.73%	7.30%	2.90%
Preferred Stock	4.69%	5.50%	0.26%
Common Equity	53.00%	9.64%	5.11%
Total	100.00%		8.29%

F. Cost of Service-*Gas & Water*

1. Gas

Staff had one issue in relation to the Gas Cost of Service Study (COSS), which related to the allocator. The Company used the average and excess (A&E) allocator. Ms. Kessinger (Company Ex. SMK-1, p. 8) explained how the Company estimates the peak day and then uses that information to develop the A&E allocator. She stated the principle underlying the A&E allocator is that fixed demand costs should be apportioned to rate classes in a manner that reflects both the basis for which costs are incurred, as well as the actual utilization of the system once it is installed.

In this case, and in past rate cases for other gas utilities, Staff has recommended the average and peak (A&P) allocator methodology. (ICC Staff Ex. 5.0, p. 4) The A&P

approach has been approved by the Commission in previous gas rate case proceedings and continues to provide the most reasonable, cost-based method for allocating these costs.

The Company agreed to Staff's recommendation and the A&P allocator was used in the COSS for this rate proceeding. (Company Ex. SMK-4, p. 3)

2. Water

Staff accepted the water COSS used by the Company. (ICC Staff Ex. 5.0, p. 12) The Company (Company Ex. LJW-1, p. 9) used the cost allocation method of "Base-Extra Capacity Method" which is consistent with current Staff recommendations.

G. Rate Design-*Gas & Water*

1. Rate Design General Discussion

The Staff rate design proposals should be adopted by the Commission in this proceeding because Staff's recommended rate designs are based on cost of service which result in each customer class being charged rates that reflect cost of service as closely as possible. Staff believes that the Company's Gas rate design proposal continues to exacerbate existing rate design inequities.

2. Gg-1 Small Service- *Gas*

Staff's proposal recommended that the Gg-1 Small Service customer charge move toward full cost of service for providing a monthly service and thus the residential usage charge has not been increased. All revenue requirement increases have been allocated to the customer charge. (ICC Staff Ex. 5.0, p. 7)

3. Gg-2 Large Service- *Gas*

Staff recommended that the Gg-2 Large Service customer class rates should not change from the existing tariff. A review of Company Ex. SMK-3.1, WPE – 2, page 1 of 10, third column of calculations the Rate of Return at Present Rates (near the bottom of the page) shows that the Gg-2 class has been over earning by a substantial amount over the Gg-1 and Gg-7 customer classes. Therefore, rates for this class should not be increased since this class is already paying significantly more than the proposed rate of return. (ICC Staff Ex. 5.0, p. 7)

The Company did not agree with Staff's recommendation. The Company recommended that all classes should be asked to shoulder some of the burden of a rate increase. (Company Ex. SMK-4, p. 5) As pointed out above this class is shouldering too much of the costs already and therefore, no increase is appropriate at this time for the class.

4. Gg-7 Interruptible –*Gas*

Staff agreed with the Company's recommendation of implementing a customer charge for the Interruptible rate class Gg-7. The customer charge includes fixed costs such as meter reading and billing costs. All customer classes should pay these expenses. As Ms. Kessinger's testified"…customer costs are incurred regardless of the customer's usage level." (Company Ex. SMK-1, p. 11)

Staff set the small interruptible customer charge to recover most of the cost of this class as shown on Company Ex. SMK-3, WPE – 2, page 7 of 14, in the 4th column of calculations at the bottom of the page. Staff set the large interruptible customer charge equal to that for Gg-2 so that customers would not see a decrease in the

customer charge if moving from the Gg-2 rate to the Gg-7 rate. Staff also recommends increasing the usage charge for the interruptible class given that an interruption for these customers hasn't occurred since 1996. These customers have very little risk of interruption and receive quite a discount on the usage rates. (ICC Staff Ex. 5.0, p. 8)

5. Customer and Usage Charges- *Water*

Staff agreed on the rate design that was used from the COSS to design the customer and usage charges for all customer classes. The customer charge and the usage charge have only been changed to reflect Staff's revenue requirement and can be found on ICC Staff Ex. 5.0, Schedule 5.1 Water. (ICC Staff Ex. 5.0, p. 12)

6. Public and Private Fire Water Rates-*Water*

Staff concurred with the public and private fire protection rates as specifically proposed by the Company. (ICC Staff Ex. 5.0, p. 13)

II. Rates, Rules and Tariff Issues-*Gas & Water*

A. Gas Tariff Volume No. 10/11-*Gas*

The Company has updated its Gas Tariff from their 1985 rate case filing with typo corrections and reorganization of the material in the tariffs. Staff noted two areas of concern in the General Rules and Regulations as proposed in Gas Tariff Volume No. 11 replacement. (ICC Staff Ex. 5.0, p. 9)

The Company agreed to Staff's recommendations to delete the wording upon application of service "for a period of one year" on Original Sheet No. 15, Section 1,

Application for Service. Staff also recommended changing the tariff language to reflect that it is not necessary to "sign the application" as service may be applied for via the phone. (Company Ex. SMK-4, p. 6).

The second change Staff recommended is on Original Sheet No. 15.1, Section 6. Deposit or Security Required. (ICC Staff Ex. 5.0, p. 102) Staff recommended replacing the language in the third paragraph of the proposed tariff with the language that describes the current method for determining the interest rate. This was effective May 1, 2002, and is derived from Docket No. 01-0801. The Company agreed to the language change. (Company Ex.SMK-4, p. 6)

B. Annual Usage Review Process-*Gas*

Staff recommended the Commission approve the annual usage review as proposed by the Company. The review process for each account will provide a beneficial service to customers and ensure they are being served under the appropriate rate schedule. If a customer's annual usage levels deviate by plus or minus 5,000 therms from the usage classifications, the Company is proposing to move the customers to the applicable rate schedule. The annual usage review would be performed in April and become effective on the customer's next bill. (ICC Staff Ex. 5.0, p. 11)

C. Service Lateral Costs-*Gas*

Staff recommended the Commission approve the Service Lateral Costs as proposed by the Company. The Company proposed changing the charge for Plastic 1 inch or less service pipe from a $2.50 incremental charge per foot to $3.65. It proposed

the Plastic 2 inch service pipe should increase from a $3.65 incremental charge per foot to $6.25. The Company is also adding a Steel 2 inch service pipe size with a charge of $9.80 per incremental foot. (ICC Staff Ex. 11.0, p. 2)

D. Water Tariffs through Ill. C.C. No. 8-*Water*

The Company proposed to update its current Rates, Rules, Regulations, and Conditions of Water Service tariffs ("Water Tariffs"). The Water Tariffs first became effective in 1985 and have not been revised since that time. Since 1985, the format of the Water Tariffs became outdated and required updating. The Company proposed Final Water Tariffs (Ill. C. C. No. 8). In conjunction with implementation of proposed Final rates, the Company proposed to replace the current Water Tariffs in its entirety, and the proposed Interim Water Tariffs (Ill. C. C. No. 7), with the proposed Final Water Tariffs (Ill. C. C. No. 8) in order to update the format of the Water Tariffs. The only substantive changes, other than formatting, in the proposed Final Water Tariffs were the Final rate increases and the introduction of the Purchased Water Surcharge Rider and Information Sheet. (Company Ex. LJW-1, pp. 13-14; Company Ex. MWS-1 Water, pp. 11-12; ICC Staff Ex. 6.0, p. 4)

Staff reviewed the Company's proposed Water Tariffs and agreed that the only changes, other than formatting, in the proposed Final Water Tariffs were the Final rate increases and the introduction of the Purchased Water Surcharge Rider and Information Sheet. (ICC Staff Ex. 6.0, p. 5) Staff recommended changes to the Company's proposed Final Water Tariffs in accordance with 83 Ill. Adm. Code 255, 280, and 655 of the Commission's regulations and in order to be consistent with Water Tariffs currently in effect and on file with the Commission. (ICC Staff Ex. 6.0, pp. 5-11)

The Company presented a complete revised set of proposed Final Water Tariffs reflecting Staff's recommended changes for which the Company agreed with. (ICC Staff Ex. 6.0, p. 12; Company Ex. LJW-4, p. 2; ICC Staff Ex. 12.0, p. 1) The Company proposed an additional change to its proposed Final Water Tariffs that was not addressed in Staff's Direct Testimony. The single revision was a change to the Water Main Extension Rules to comply with the current provisions of the Commission's Regulations at 83 Ill. Adm. Code 600.370. (Company Ex. LJW-4, pp. 2-3; ICC Staff Ex. 12.0, pp. 2 and 6)

Staff reviewed the Company's proposed Final Water Tariffs and agreed that the revisions to the Final Water Tariffs incorporated all of Staff's recommended changes. (Company Ex. LJW-4, p. 2; ICC Staff Ex. 12.0, p. 2) Staff reviewed the Water Main Extension Rules of the Company's proposed Final Water Tariffs and agreed that the change complies with the current provisions of the Commission's Regulations at 83 Ill. Adm. Code 600.370. (ICC Staff Ex. 12.0, p. 3) Staff recommended further changes to the Water Main Extension Rules of the Company's proposed Final Water Tariffs so that the Company's Water Main Extension Rules are in compliance with 83 Ill. Adm. Code 600.370 of the Commission's regulations. (ICC Staff Ex. 12.0, pp. 3-6)

The Company presented a revised version of the Water Main Extension Rules of the Company's proposed Final Water Tariffs reflecting Staff's recommended changes for which the Company agreed with. (ICC Staff Ex. 12.0, p. 6; Company Ex. LJW-6, p. 2) The revisions to the Water Main Extension Rules of the Company's proposed Final Water Tariffs incorporated all of Staff's recommended changes. (Company Ex. LJW-6, p. 2) The Company and Staff are in complete agreement.

With respect to the Purchased Water Surcharge that was a part of the Company's initial filing Staff witness Smith expressed concern that the rates to be charged for water purchased by SBWGE from the City of Beloit, Wisconsin will be regulated by the sovereign state of Wisconsin. Mr. Smith further emphasized that at the time of annual reconciliations, the prudence of water purchases should be reviewed, including review of public information available relative to rate setting, and other proceedings before the Public Service Commission of Wisconsin. (ICC Staff Ex. 3.0, pp. 3-8)

Staff and the Company are in agreement that a purchased water surcharge rider is appropriate for SBWGE and the rider should be approved.

E. Water Tariffs through Ill. C.C. No. 7-*Water*

The Company proposed Interim Water Tariffs (Ill. C. C. No. 7). The proposed Interim Water Tariffs consisted of a Revised Sheet No. 6 that reflected adjusted base rates (removal of water production costs) and the adoption of the Purchased Water Surcharge Rider, new Sheet Nos. 30-33 that comprised the Purchased Water Surcharge Rider, and an Information Sheet that established the expected Purchased Water Surcharge resulting from the Wholesale Water Contract. (Company Ex. LJW-1, pp. 13-14; Company Ex. MWS-1 Water, pp. 11-12; ICC Staff Ex. 6.0, p. 4)

Staff recommended that the Commission cancel and annul the Company's proposed Interim Water Tariffs. (ICC Staff Ex. 3.0, pp. 8-9; ICC Staff Ex. 6.0, pp. 11-12; ICC Staff Ex. 12.0, pp. 6-7) The Company did not challenge Staff's recommendation.

F. Compliance Tariff Filing-*Gas & Water*

Staff recommended the Commission order the Company to file new Rate, Rules, Regulations and Conditions of Service tariffs within ten (10) days of the Commission Order, with an effective date of not less than ten (10) business days after the date of filing, for service rendered on and after their effective date, with individual tariff sheets to be corrected within that time period if necessary. (ICC Staff Ex. 6.0, p. 12; ICC Staff Ex. 11.0, p. 3; ICC Staff Ex. 12.0, p. 7)

III. Other Issues-*Gas & Water*

A. Original Cost Determination-*Gas & Water*

The Commission should make an original cost determination in this proceeding. Requirements for preservation of records are associated with an original cost determination. 83 Ill. Adm. Code 510, The Preservation of Records of Gas Utilities, Appendix A and 83 Ill. Adm. Code 615, The Preservation of Records of Water Utilities, Appendix A, contain requirements for the preservation of specific records. For example, journal vouchers and journal entries which support plant accounts are to be maintained "7 years prior to date as of which original cost of plant has been unconditionally determined or approved by the Commission in" an original cost determination proceeding or a rate case.

Staff requests that the Commission include the following provision in this proceeding's order:

> It is further ordered that the original cost of gas plant at December 31, 2002, as reflected on Company Ex. MWS-1 Gas, Schedule B-2, line 10,

column (G) of $11,192,009 is unconditionally approved as the original cost of gas plant for consideration of 83 Ill. Adm. Code 510.

It is further ordered that the original cost of water plant at December 31, 2002, as reflected on Company Ex. MWS-1 Water, Schedule B-2, line 15, column (G) of $6,088,177 is unconditionally approved as the original cost of water plant for consideration of 83 Ill. Adm. Code 615.

(ICC Staff Ex. 1.0, p. 3)

It is Staff's belief that its original cost determination recommendation is an uncontested issue given that the Company did not take issue with the recommendation in its rebuttal or surrebuttal testimony.

B. Contract Between WPL and SBWGE for Gas-*Gas*

Staff recommends that the Commission order the Company to file a petition requesting Commission approval of a new gas contract between SBWGE and WPL within six months of the order date in this proceeding. The reason for Staff's recommendation is that the methodology utilized in the current gas contract effectively replaces all direct costs incurred by SBWGE with a percentage allocation of WPL's total costs.

The Company asserts that a new gas contract is unnecessary because the current gas contract allows the direct costs incurred by SBWGE to remain on its books, along with an incremental allocation of costs from WPL.

Accordingly, this contested issue turns on whether the current gas contract does, in fact, provide for direct costs and rate base to remain on the books of SBWGE, with only an incremental allocation of indirect costs and rate base from WPL, or whether the current gas contract effectively replaces the direct costs incurred by SBWGE with a percentage allocation of WPL's total costs.

The Company's Contract For Gas with WPL dated June 20, 1997 (Docket No. 97-0088) provides the basis for the costs recorded by SBWGE to produce its financial information. The current gas contract uses an allocation methodology wherein gas operations and rate base are derived by allocating a percentage of WPL's total gas costs and rate base to SBWGE, based on sales of gas by SBWGE proportionate to combined gas sales of SBWGE and WPL, or based on the number of SBWGE customers proportionate to combined customers for SBWGE and WPL (ICC Staff Cross Exhibit 2 - Seitz)

The Company has a similar contract with WPL for its water operations. Recently, the Commission approved a new water services contract between SBWGE and WPL (ICC Docket No. 03-0462, Order entered March 17, 2004), which changes the method by which SBWGE is allocated costs for the water services it receives from WPL. The new methodology reflects all direct costs incurred by SBWGE plus an allocation for certain incremental indirect costs from WPL.

It is Staff's contention that the allocation methodology contained in the new water services contract is superior to the allocation methodology reflected in the current gas contract because it reflects the actual costs directly incurred by SBWGE along with a proportion of allocated costs from WPL. Staff asserts that the methodology utilized in the current gas contract effectively replaces all direct costs incurred by SBWGE with a percentage allocation of WPL's total costs. This is apparent from a review of Formulas 2 through 5 of the existing gas contract. (ICC Staff Cross Ex. 2 - Seitz) It is also evident from the allocation of rate base to SBWGE, as detailed on Schedules B-1 and B-6 attached to the direct testimony of Company witness Martin W. Seitz. (Exhibit

MWS-1, Schedules B-1 and B-6, respectively)

Schedule B-6 derives the average rate bases for WPL and SBWGE, respectively, and adds the two averages to derive a combined average rate base. The allocation factor is applied to the combined average to derive the total allocation to SBWGE. From that amount the direct SBWGE rate base is deducted to derive the allocation of rate base to SBWGE per the existing contract. This amount is then added back to the direct SBWGE rate base on Schedule B-1. The theoretical effect of this methodology is that the allocation per the contract acts as a plug amount to get the direct SBWGE amount back to the allocated total that was derived on Schedule B-6. The only difference between the total rate base per Schedule B-1, column (D), and Schedule B-6, column (H) is due to the fact that Schedule B-6 uses average balances instead of the year–end balance that appears on Schedule B-1. Given that the current methodology produces costs based on estimated allocations, Staff asserts that actual cost information would be superior to the extent it is available. The Company contends that the costs and assets that directly relate to SBWGE stay on its books, and only an incremental amount is allocated, based on the formulas. Therefore, the Company asserts there is no justification for changes to the existing gas contract. Staff agrees that the direct costs incurred by SBWGE remain on its books, however, Staff argues that the effect of the allocation methodology used by the Company is that regardless of the amount of the direct costs on SBWGE's books, the final amounts on SBWGE's books will reflect the allocation of the combined SBWGE and WPL costs, thereby effectively replacing the direct costs with an allocation.

Staff's primary concern is that the rates charged to SBWGE customers reflect, to the extent possible, the actual costs incurred to provide service. Assigning costs directly to SBWGE, with allocations only for indirect/un-assignable costs that are necessary to provide gas service to SBWGE customers, would accomplish this objective.

This approach would be consistent with the Company's stated intention in assigning costs among WPL, SBWGE and Interstate Power and Light Company ("IPL") in the Amended and Restated Service Agreement (Public Utility Companies) between WPL, SBWGE and Interstate Power and Light Company ("IPL"). Article II, Section 2.2 of the Amended and Restated Service Agreement (Public Utility Companies) between WPL, SBWGE and IPL states:

> "It is the intent of this Agreement that charges for services shall be distributed among the Client Companies, to the extent possible, based upon direct assignment."

Staff recommends that the Commission order the Company to file a petition requesting Commission approval of a new gas contract between SBWGE and WPL within six months of the order date in this proceeding. The new gas contract should allow direct costs and rate base components that are directly assignable to SBWGE to remain in its financial records. Allocations from WPL should only represent SBWGE's share of such incremental items as common and general rate base, and certain costs that are not directly assignable to a specific entity at the time they are incurred, like the methodology used in the new water services contract approved in ICC Docket No. 03-0462. To the extent possible under the new ERP system, SBWGE's books and records should reflect rate base, income and expenses that are directly assignable to SBWGE.

CONCLUSION

Wherefore, for the foregoing reasons, the Staff of the Illinois Commerce Commission respectfully requests that the Commission accept Staff's recommendations.

Respectfully submitted,

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JOHN C. FEELEY
Office of General Counsel
Illinois Commerce Commission
160 North LaSalle Street
Suite C-800
Chicago, Illinois 60601
(312) 793-2877

Counsel for the Staff of the
Illinois Commerce Commission

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